

Message Text

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ACTION EA-09

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P R 240618Z JUN 77

FM AMEMBASSY SEOUL

TO SECSTATE WASHDC PRIORITY 4693

INFO AMEMBASSY TOKYO

AMCONSUL HONG KONG

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HONG KONG PASS REG FINATT

EO 11652: N/A

TAGS: EALR, ECON, EFIN, ETRD, KS

SUBJECT: KOREA MAKES READY TO INTRODUCE THE VALUE ADDED TAX

REF: (A) SEOUL 5049; (B) SEOUL 5109

BEGIN UNCLASSIFIED

SUMMARY: WITH THE JUNE 13 ANNOUNCEMENT BY THE PRESIDENT'S OFFICE THAT THE VALUE ADDED TAX WOULD GO INTO EFFECT AS SCHEDULED JULY 1, IT WOULD APPEAR THAT THE VAT DEBATE, DESPITE CONTINUED RUMBLINGS, HAS BEEN ENDED TO ALL INTENTS AND PURPOSES. AT THE SAME TIME, RECOGNIZING THAT THE VAT WOULD CAUSE INFLATIONARY PRESSURE, THE GOVERNMENT LOWERED THE INITIAL RATE AND ANNOUNCED AN EXTENSIVE STABILIZATION PROGRAM WHICH INCLUDES PROVISIONS AFFECTING ALL SECTORS OF THE ECONOMY. NEVERTHELESS, IN LIGHT OF THE RATE OF REDUCTION, WHICH THEY VIEW AS A VICTORY, OPPONENTS OF THE VAT, BOTH

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POLITICIANS AND BUSINESSMEN, STILL SEEM DETERMINED TO CONTINUE TO SEEK POSTPONEMENT OF VAT IMPLEMENTATION.

END SUMMARY.

1. ONE JUNE 13 THE PRESIDENT'S OFFICE ANNOUNCED THAT THE VALUE ADDED TAX (VAT) WILL GO INTO EFFECT ON JULY 1, AS SCHEDULED. THE RATE, HOWEVER, WILL BE 10 PERCENT, NOT THE

BASE RATE OF 13 PERCENT AS HAD BEEN PREVIOUSLY PLANNED. THE RATE DECISION WAS MADE PERSONALLY BY PRESIDENT PARK. THIS WOULD APPEAR TO BE A SMALL VICTORY FOR OPPONENTS OF THE VAT; BEFORE AND AFTER THE PASSAGE OF THE VAT IN 1976 THERE HAD BEEN DIRE WARNINGS FROM SEVERAL QUARTERS OF THE BURDENS IT WOULD ENTAIL. WHILE THE OPPOSITION NATIONAL DEMOCRATIC PARTY (NDP) FOCUSED ON THE ADVERSE EFFECTS IT WOULD HAVE ON THE ECONOMY, THE BUSINESS COMMUNITY POINTED TO THE DIFFICULTY IN ADMINISTERING THE NEW SYSTEM BOTH FOR GOVERNMENT AND FOR BUSINESSMEN, ESPECIALLY WORKING WITH A 13 PERCENT RATE. THE CLINCHER FOR THE GOVERNMENT WAS THEIR OWN STUDY THAT AT 13 PERCENT THE VAT WOULD ADD 3.4 PERCENT TO THE WHOLESALE PRICE INDEX; THE 10 PERCENT RATE, ACCORDING TO THE STUDY, SHOULD HAVE A NEUTRAL EFFECT. THE REDUCTION OF THE RATE, THE ECONOMIC PLANNING BOARD (EPB) ESTIMATES, WILL COST THE GOVERNMENT 60 BILLION WON IN TAXES. THE MINISTRY OF FINANCE (MOF), HOWEVER, IS CONSIDERING INCREASING THE SPECIAL EXCISE TAX RATE BY UP TO 30 PERCENT ON 29 LUXURY ITEMS TO MAKE UP SOME OF THE REVENUE LOSS.

2. ON JUNE 14 THE DEPUTY PRIME MINISTER, NAM DUCK-WOO, ANNOUNCED A SERIES OF ECONOMIC MEASURES THE GOVERNMENT HAS PROPOSED TO REDUCE INFLATIONARY PRESSURES, WHICH HAVE GROWN IN THE FIRST HALF OF 1977 AS A RESULT, INTER ALIA, OF MONEY SUPPLY INCREASES CAUSED BY INFLOWS FROM THE FOREIGN SECTOR. THE GOVERNMENT FEARS THAT THE VAT MAY ADD LIMITED OFFICIAL USE

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TO THESE IN THE SECOND HALF. THE FOLLOWING IS A SUMMARY OF THE MEASURES BY SECTOR:

A. FISCAL POLICY:

- (1) RESTRICT GOVERNMENT SPENDING SO AS TO BALANCE THE OVER-ALL FISCAL ACCOUNT, INCLUDING THE FERTILIZER FUND AND TO MINIMIZE THE DEFICIT IN THE GRAIN MANAGEMENT FQHD (GMF).
- (2) EARMARK 50 BILLION WON OF THE FY 76 SURPLUS TO REPAY GOVERNMENT BORROWINGS FROM THE BANK OF KOREA AND INCREASE SALE OF GOVERNMENT SECURITIES BY 50 BILLION WON.

B. FOREIGN TRADE:

- (1) LIMIT NET FOREIGN ASSETS INCREASE IN 1977 TO \$1BILLION.
- (2) EXPAND THE LIST OF IMPORTS WHICH DO NOT REQUIRE PRIOR GOVERNMENT APPROVAL. THE LIST IS STILL BEING DETERMINED.
- (3) REDUCE PRIOR IMPORT DEPOSIT RATES IN TWO STEPS ON JULY 1 AND OCTOBER 1. A MINIMUM DEPOSIT RATE OF 10 PERCENT WILL BE MAINTAINED.

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PRIOR IMPORT DEPOSIT REQUIREMENTS:

(A) AT SIGHT IMPORTS PREVIOUS RATES AS OF 7/1/77 10/1/77

RAW MATERIALS FOR EXPORTS 15 10 10-20

ITEMS ELIGIBLE FOR DEFERRED

PAYMENT 35-65 15-30 10-20

FOR DEFENSE INDUSTRY 100 10 10

LUXURY AND NON-ESSENTIAL ITEMS

(OVER 50 PERCENT OF TARIFF)

INCLUDING SUPPLEMENTARY LIST

DESIGNATED BY MCI 200 150 100

OTHERS 100-110 70 40

(B) DEFERRED PAYMENT IMPORTS:

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RAW MATERIALS FOR EXPORTS 15 10 10

ESSENTIAL EXPORT RAW MATERIALS

(10 ITEMS-SEE SEOUL A-48) 20-35 20 20

FOR DEFENSE INDUSTRY 40 10 10

OTHERS 40-80 40 40

(4) LOWER TARIFF RATES ON SELECTED MAJOR IMPORTS, PRINCIPALLY MATERIALS FOR EXPORTS. THE ITEMS HAVE NOT YET BEEN ANNOUNCED.

(5) AMEND THE DRAWBACK SYSTEM LAW TO PROVIDE FOR TARIFF REDUCTION FOR IMPORTS OF WHICH 80 PERCENT OR MORE IS USED FOR EXPORT PRODUCTION. THE REDUCTION WILL BE PROPORTIONATE TO THE AMOUNT USED FOR EXPORT, E.G., FOR A PRODUCT FOR WHICH THE NOMINAL TARIFF RATE IS 10 PERCENT AND OF WHICH 90 PERCENT IS EVENTUALLY EXPORTED THE IMPORTERS WILL PAY 1 PERCENT DUTY, I.E., 10 PERCENT OF THE TARIFF OF 10 PERCENT. THE GOVERNMENT IS PRESENTLY COMPILING THE LIST OF PRODUCTS WHICH WOULD QUALIFY.

(6) DESIGNATE AS BONDED AREAS THE MANUFACTURING PLANTS OF EXPORTERS WHO EITHER IMPORT NUMEROUS RAW MATERIALS AND INTERMEDIATES, SUCH AS ELECTRONICS MANUFACTURERS, OR FOR WHOM THE PRODUCTION TIME IS EXTENDED, LIKE SHIPBUILDING. FOR THE DESIGNATED MANUFACTURER, NO IMPORT DUTIES WILL BE IMPOSED. THE AMENDMENT OF THE LAW WILL BE CONSIDERED BY THE SPECIAL SESSION OF THE NATIONAL ASSEMBLY NOW SITTING.

C. CREDIT:

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(1) LOWER INTEREST RATES ON BANK LOANS AND TIME DEPOSITS IN TWO PHASES; FOR COMMERCIAL LOANS THE INTEREST RATE WILL BE REDUCED BY 1 PERCENT ON JULY 1 AND ANOTHER 1 PERCENT ON OCTOBER 1 FROM THE PRESENT 18 PERCENT. FOR TIME DEPOSITS, THE INTEREST RATE WILL DECLINE 1.8 PERCENT ON OCTOBER 1 FROM THE PRESENT 16.2 PERCENT.

(2) RAISE THE LIMIT FOR CREDIT EXPANSION TO AN AVERAGE 80 BILLION WON PER MONTH FOR THE FINAL SEVEN MONTHS OF 1977. FOR THE FIRST FIVE MONTHS, CREDIT HAD EXPANDED BY A MONTHLY AVERAGE OF 70 BILLION WON.

(3) ADD 50 BILLION WON TO THE GOVERNMENT FUND FOR CREDIT

TO SMALL INDUSTRIES MAKING THE 1977 TOTAL 150 BILLION WON
(\$310 MILLION).

D. PRICE CONTROLS:

(1) IMPOSE PRICE CEILINGS FOR 850 PRODUCTS. ON THE BASIS
OF GOVERNMENT SURVEYS, THE GOVERNMENT WILL DESIGNATE THE
PRODUCTS FOR WHICH PRICE MAY BE CHANGED, EFFECTIVE JULY 1,
BASED ON THE EFFECT OF THE VAT. OF THE TOTAL, 470 WILL
BE ALLOWED INCREASES, 270 WILL BE LOWERED AND 100 MUST
REMAIN UNCHANGED. PRICES PREVAILING ON MAY 31 WILL BE THE
BASIS FOR THE DETERMINATION.

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(2) REVISE THE LIST OF MONOPOLISTIC AND OLIGOPOLISTIC
(M&O) PRODUCTS CONTROLLED UNDER THE FAIR TRADE AND PRICE
STABILIZATION LAW (SEE SEOUL A-55 OF APRIL 23, 1976). THE NEW
LIST INCLUDES 157 M&O PRODUCTS AS WELL AS 95 "ESSENTIAL GOODS".

(3) SET LIMITS ON WHOLESALE AND RETAIL PROFIT MARGINS.
FOR WHOLESALE DISTRIBUTORS, THE OFFICE OF NATIONAL TAX
ADMINISTRATION WILL DRAW UP GUIDELINES, AND FOR RETAIL
OUTLETS, THE GOVERNMENT REQUIRES THAT 102 PRODUCTS BEAR
PRICE TAGS. A TOTAL OF 38,524 RETAIL STORES ARE AFFECTED.

(4) RESTRICT PRICE CHANGES FOR PUBLIC UTILITIES. THE
GOVERNMENT RESTRAINTS ON PRICE RISES ARE TO APPLY TO RAIL-

WAY, COMMUNICATIONS, WATER AND TUITION CHARGES. BUS FARES AND HOUSEHOLD ELECTRICITY RATES WILL BE HELD AT PRESENT LEVELS THROUGH THE BALANCE OF 1977.

(5) PLACE AGRICULTURAL AND MARINE PRODUCTS UNDER SPECIAL CONTROLS. THE GOVERNMENT WILL ATTEMPT TO STABILIZE GRAIN PRICES AND MONITOR EXPORTS TO ASSURE THAT DOMESTIC DEMAND LIMITED OFFICIAL USE

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AND PRICES ARE NOT ADVERSELY AFFECTED. IN ADDITION, AUTHORIZATION TO IMPORT 5000 METRIC TONS OF BEEF AS WELL AS PEANUTS AND SOYBEANS WILL BE GIVEN. THE PRICE OF BEEF WILL BE CONTROLLED BY THE GOVERNMENT.

(6) REQUIRE ESTABLISHMENTS WHICH PROVIDE COMMONLY USED SERVICES ALREADY SUBJECT TO GOVERNMENT CONTROL TO DISPLAY A PRICE LIST. THE NUMBER OF CONTROLLED SERVICES WAS INCREASED FROM 6 TO 9.

(7) ISSUE REGULATIONS TO STRENGTHEN THE ADMINISTRATION OF PRICE CONTROL.

3. TWO CHANGES HAVE BEEN MADE TO THE ECONOMIC PROJECTIONS FOR 1977. IN THE EXTERNAL SECTOR THE GOVERNMENT NOW FORESEES A BALANCE IN THE CURRENT ACCOUNT IN PLACE OF THE \$484 MILLION DEFICIT ANTICIPATED, AND INTERNALLY THE CEILING FOR MONEY SUPPLY EXPANSION HAS BEEN REVISED FROM 22-24 PERCENT TO 28 PERCENT. WITH THE STEPS THAT HAVE BEEN TAKEN, RATHER THAN A RISE IN PRICES AS A RESULT OF THE VAT, THE GOVERNMENT NOW CLAIMS THAT NET EFFECT WILL BE A DECLINE OF 1.3 PERCENT IN THE WHOLESALE PRICE INDEX. THIS HAS BEEN DISPUTED BY THE BANK OF KOREA WHICH POINTS OUT THAT THE PRINCIPAL INCREASES IN PRICES TO DATE HAVE BEEN IN AGRICULTURAL ITEMS WHICH, IN GENERAL, REMAIN OUTSIDE THE VAT, AND WHERE, ACCORDING TO THE BOK, ENFORCEMENT OF PRICE CONTROL IS ESPECIALLY DIFFICULT.

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4. ALTHOUGH NEWSPAPER ACCOUNTS INDICATED THAT THE BUSINESSMEN'S GROUPS WERE MOLLIFIED BY THE REDUCTION IN THE VAT RATE, ACCORDING TO FEDERATION OF KOREAN INDUSTRIES (FKI) OFFICIALS LIMITED OFFICIAL USE

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RATE REDUCTION WAS ONLY PART OF THEIR REQUEST. FKI WOULD LIKE TO SEE THE VAT PUT OFF SIX MONTHS UNTIL JANUARY 1, 1978,

AND WILL KEEP AGITATING, QUIETLY, FOR POSTPONEMENT. ACCORDING TO KNOWLEDGEABLE OPPOSITION SOURCES, NDP WILL SIMILARLY ATTEMPT TO POSTPONE IMPLEMENTATION OF THE VAT FOR A MINIMUM OF EIGHTEEN MONTHS; THEY WOULD PREFER A LONGER DELAY. THE OPPOSITION WILL SEEK FURTHER TO DRAMATIZE THE ISSUE BY SENDING WIVES OF NDP ASSEMBLYMEN TO CHECK PRICES ON A DAILY BASIS DURING THE SPECIAL SESSION OF THE NATIONAL ASSEMBLY SO THAT ANY SIGNIFICANT RISE ATTRIBUTABLE TO THE VAT CAN BE PUBLICIZED. END LOU

COMMENT: AT THIS POINT, IT WOULD BE EXTREMELY DIFFICULT FOR THE GOVERNMENT TO REARRANGE ACTIONS IT HAS TAKEN IN ORDER NOW TO POSTPONE IMPLEMENTATION OF VAT. THE ADOPTION OF THE "SABILIZATION PROGRAM" WAS ONLY IN PART DUE TO THE VAT. THERE ARE OTHER PROBLEMS, MOST NOTABLY THE INFLATIONARY PRESSURE OCCASIONED BY THE INFLOW OF MONEY FROM THE FOREIGN SECTOR, WHICH HAD TO BE ADDRESSED. THE MEASURES HAVE BEEN DRAWN UP WITH BOTH ENDS IN MIND; TO POSTPONE THE VAT WOULD UPSET THE BALANCE. IN ANALYZING THE GOVERNMENT PROGRAM, IT WOULD SEEM THAT THERE WAS ALMOST AS MUCH CONCERN FOR THE EFFECTS OF THE VAT ON EXPORT PRICES AS ON DOMESTIC INFLATION. THE VAT WHICH IS FIRST PAID, THEN REBATED, TOGETHER WITH OTHER IMPORT DUTIES, ALSO SUBSEQUENTLY REBATED, COULD INITIALLY TIE UP A LOT OF THE EXPORTING FIRMS' FUNDS, THEREBY RAISING COSTS BECAUSE OF THE NECESSITY TO BORROW MORE FOR WORKING CAPITAL. CONSEQUENTLY, THE GOVERNMENT HAD TO MAKE CHANGES IN THE PRIOR IMPORT DEPOSIT SYSTEM, THE TARIFF DRAWBACK LAW AND INTEREST RATES. AS A RESULT, THE GOVERNMENT NOW CLAIMS BUSINESS COSTS WILL BE REDUCED BY 163.4 BILLION WON DURING THE REMAINDER OF 1977 AND WILL MORE THAN OFFSET THE 76.1 BILLION WON COST INCREASES BECAUSE OF VAT. AS CAN BE SEEN FROM THE LARGE NUMBER OF CONTROL MEASURES ANNOUNCED, THEIR IMPOSITION, AS WELL AS THAT OF THE VAT, WILL INCREASE THE BUREAUCRATIC BURDENS ON BUSINESS LIMITED OFFICIAL USE

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AND PROVIDE BOTH BUSINESSMEN AND GOVERNMENT OFFICIALS WITH A PROPORTIONATE SHARE OF HEADACHES AND PROBLEMS FOR THE NEXT FEW MONTHS. WHAT THE EFFECTS ON THE ECONOMY WILL BE IS ONE OF THE MORE INTERESTING QUESTIONS WHICH REMAINS TO BE ANSWERED.
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